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SUBJECT: NEPAL: NEW GOVERNMENT UNVEILS AMBITIOUS BUDGET

REF: KATHMANDU 807

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#### Summary

1. (U) On September 19, Nepal's new Finance Minister, Dr. Baburam Bhattarai, presented an ambitious budget of NRs 236 billion (USD 3.2 billion) -- 40 percent higher than last year's budget. Bhattarai stated that the policy priorities for the budget were completion of the peace process and immediate relief for those affected by the conflict, followed by accelerated economic growth, social security and inclusion. The budget includes a revenue forecast that is 32 percent higher than last year's revised estimate. Increases are expected to come through improved tax collection. The budget contains a number of ambitious populist programs with a 60 percent increase in the estimated capital expenditures. Foreign grants are forecast to increase by over 100 percent to be over NRs 47 billion (USD 644 million). In his budget speech Bhattarai explained that the private sector and the cooperative sector are the "two legs" of the transitional economy and a policy of "balanced walking with these two legs will be actively pursued." Many of the proposed programs are loosely defined and raise concerns over moneys being misused, misdirected and manipulated. It will be important to monitor how programs are implemented to determine their true purpose. The proposed creation of an Economic Council, a Cooperative Board and the revival of defunct state owned enterprises signals that the new Government of Nepal (GON) intends to take a controlling role in the economy. It also creates a new level of uncertainty in the private sector.

#### Bhattarai Presents 236 Billion Budget

2. (U) On September 19, Nepal's new Maoist Finance Minister, Dr. Baburam Bhattarai, presented the first budget of the Federal Democratic Republic of Nepal. Bhattarai defended the whopping NRs 236 billion budget (USD 3.2 billion), which is 40 percent higher than last year's budget, by explaining that "some risks must be taken when you want to take a leap forward." Bhattarai stated that the policy priorities for

the budget were completion of the peace process and immediate relief for those affected by the conflict, followed by accelerated economic growth, social security and inclusion. Sectoral priorities were listed as the transformation of the agriculture sector, development of water resources, wider expansion of tourism, expansion of physical infrastructure, human resource development and national industrialization. Bhattarai emphasized that the 65 percent increase in capital expenditure is proof that the budget is focused on development. The Finance Minister defended the huge size of the budget claiming that the budget's parameters were within international macroeconomic norms and would push the growth rate to over 7 percent this year.

--(Note: The Nepali fiscal year runs from July 15 to July 14. On July 15, 2008, due to the delay in the formation of a new government, the Constituent Assembly passed a temporary bill allowing routine government operations until a complete fiscal year budget could be presented. Nepal's growth rate last fiscal year was 5.6 percent -- the highest growth rate in last seven years. Reftel)

#### Revenue Projected to Grow by 32 Percent

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13. (U) The budget includes a revenue forecast of nearly NRs 142 billion (USD 1.9 billion), a 32 percent increase over last year's revised estimate. Increases are expected to come through improved tax collection. Value-added tax (VAT) is projected to increase by 10 percent. With new duties on cigarettes, beer and liquor, excise duties are expected to rise by 19 percent. A new education service tax which levies a 5 percent tax on fees collected by private schools is

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forecast to bring in an additional NRs 100 million (USD 1.3 million) and a similar tax on fees collected by private health care providers is projected to bring in NRs 11.3 million (USD .15 million). Both income tax and property tax are forecast to grow by over 13 percent. In order to realize the expected improvements in tax collection, the budget contains special provisions to "encourage" tax compliance. A provision for "Voluntary Disclosure of Income" allows any person to disclose taxable assets or income on which they have not paid tax in the past to avoid future penalties. Other provisions to increase revenue include mandatory income disclosures when purchasing houses, land and vehicles with values above certain limits, modifications to the existing property tax act, a revised valuation system at customs and strengthening the revenue investigation system.

#### 40 Percent Increase in Expenditures

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14. (U) Total expenditures are projected to increase by over 40 percent. Of the total estimated budget, approximately 54 percent has been allocated for recurrent expenditure (NRs 129 billion or USD 1.8 billion), 39 percent for capital expenditures (NRs 91 billion or USD 1.25 billion) and the remaining 7 percent for loan and interest payments (NRs 16 billion or USD 219 million). The estimated capital expenditures reflect a increase of over 60 percent. Budget allocations for all major sectors increased: education up 37 percent, health up 28 percent, agriculture up 1.5 percent, hydropower up 66 percent, roads up 49 percent, irrigation up 45 percent, drinking water up 49 percent and security (police and military) up 12 percent. The budget contains a number of ambitious populist programs, including an increase in the monthly allowance for elderly, widows, and disabled people. It also introduces new programs with slogans like "Our Village, Beautiful Village," "New Nepal, Healthy Nepal." Millions have been set aside for relief to conflict victims and families of "martyrs." Bhattarai stated that an "agriculture revolution should be the basis of building a new Nepal. Through the slogan "Cooperatives in Every Village, Food Storage in Every House," cooperatives be will

established in each village and small farmers will be eligible for special loan and interest waivers. The budget also calls for the formation of a High-Level Scientific Land Reform Commission to abolish feudal land ownership and production relations. Block grants to all the Village Development Committees (VDCs) will be increased by 100 percent. The budget also includes education programs to ensure free education up to grade 8 and a literacy campaign that will employ 35,000 youth across the country. There are also youth programs to promote self-employment and support vocational training.

#### The Deficit -----

15. (U) The projected deficit before foreign grants is over NRs 94 billion (USD 1.29 billion). Foreign grants are forecast to be over NRs 47 billion (USD 644 million). This is more than a 100 percent increase (last year foreign grants totaled NR 22.8 billion or USD 312 million). The deficit after foreign grants is still over NRs 47 billion (USD 644 million). Foreign loans are estimated at NRs 18.7 billion (USD 256 million) and domestic borrowing remains at NRs 25 billion (USD 342 million), the same rate as last year. There is a small amount of additional borrowing against the cash balance, but the total projected borrowing is 28.5 percent of GDP, which the International Monetary Fund considers within reasonable limits. (Note: The projected amount of foreign grants appears foolishly high. However, in reality the government will only be able to spend the funds it actually receives. It is likely that many of the budget's ambitious programs which are tied to donor funding will fail for lack of funds.)

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#### The Private Sector & Cooperative Sector: Two Legs of the Transitional Economy -----

16. (U) In his budget speech, Bhattarai explained that in the transitional economy the private sector, cooperative sector and public sector would all play a "coordinating role together." He stated that the "private sector and cooperative sector will be the two legs of this transitional economy and a policy of balanced walking with these two legs will be actively pursued." To further rapid economic growth the budget speech calls for the establishment of a high-level "Economic Council" under the chairmanship of the Prime Minister. Both an "Investment Board" and a "Cooperative Board" will work under the Economic Council. A public-private partnership approach will be utilized to "motivate domestic and foreign investors to invest in the priority sectors." More than 60 projects and programs are proposed under the campaign "Building New Nepal." A "Holding Company" will be created to revive state-run industries, including the Biratnagar Jute Mill, Birgunj Sugar Mill, Hetauda Textile and Gorakhkali Rubber Limited. Bhattarai also proposes to create a conducive and business-friendly environment. Amendments to the existing labor policy, industrial policy, foreign investment policy and trade policy are promised, as well as an act to establish special economic zones. The budget also calls for the creation of an industrial security force. The budget gives special emphasis to infrastructure development projects, including rural reconstruction and rehabilitation, hydropower projects, roads, railways and airports, and calls for the formation of an infrastructure development bank that will be a joint public-private venture. Domestic resources for small and medium-scale and foreign investment for large-scale hydropower projects will be mobilized. A high-level power sector development committee under the chairmanship of the Prime Minister will be established to ensure that 10,000 MW of hydropower will come on line in the next 10 years.

Comment

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17. (SBU) The Maoist-led government's new 2008/2009 budget is highly ambitious in its projection of expenditure and resources. The affect on Nepal's macroeconomy could be negative if the revenues cannot be increased to keep pace with the proposed social-welfare programs and debt relief. Local experts considered the projected revenue figures largely inflated - with a 15 to 20 percent increase in revenue a more reasonable estimate. Higher salaries and increased government spending could also create inflationary pressures. However, much of the proposed spending will be tied to the availability of donor funds and the government's ability to implement the projects. The larger concern may be the uncertainty the budget has created and the murky policies it promotes. There are numerous areas where funds could easily be misused, misdirected and manipulated. One example, is the proposed 100 percent increase in block grants to the VDCs. Although these grants are likely to be under-dispersed, the existing political vacuum and complete absence of accountability in the VDCs leaves the door open for misuse. There is considerable speculation that the programs in a number of areas are designed to employee members of the Maoist Young Communist League (YCL). It will be important to monitor how programs are implemented to determine the Maoists' true intentions. The level of coercion the GON is willing to use to meet revenue targets will be another important indicator.

18. (SBU) Understandably, private sector confidence is faltering. By placing both the Cooperative Board and the Investment Board under the Economic Council, the GON is clearly indicating that it intends to take a controlling role in the economy. The interests of these two boards are sure to collide and there is the real possibility of private

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sector investment being crowded out. The promise to inject money into defunct state enterprises completely comprises efficiency and productivity in favor of a populist political agenda of creating employment. Although Bhattarai defends the inflated budget by preaching that the government must be ambitious to succeed, many of the policies promoted in the budget are simply not in line with proven economics and Nepal's realities. History has shown that state-run economies eventually fail. Moreover for the private sector "leg" to succeed in Nepal, there must first be reform in the existing institutions which are marred by inefficiency -- such as the customs department, taxation system, judiciary, education, financial sector and government bureaucracy. Until reforms in these sectors are supported, Nepal is unlikely to see any private sector led economic growth or anywhere near the double digit growth the Maoist are advertising.

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